Franchise Tax Board

ANALYSIS OF AMENDED BILL

Authors:	Runner/Harman	Analyst:	Scott McFarlane	Bill Number:	SB 1242
Related Bills:	See Legislative History	Telephone:	845-6075	Amended Date:	March 24, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Mortgage Debt Forgiveness Relief / Credit for Contributions to Nonprofit HUD-Approved Credit Counseling Agency / FTB to Report Annually to Legislature on Amount Claimed

SUMMARY

Under the Personal Income Tax law, this bill would do the following:

- Provide an exclusion from gross income for qualified debt forgiveness on a principal residence, up to a maximum of $2 million, and
- Allow taxpayers engaged in the real estate business a credit for contributing to a credit counseling agency that assists homeowners with mortgage problems.

SUMMARY OF AMENDMENTS

The bill as introduced on February 14, 2008, was a spot bill. The March 24, 2008 amendments would do the following:

- Generally conform California law to the recently-enacted federal Mortgage Forgiveness Debt Relief Act of 2007, which generally provides for an exclusion from gross income for qualified debt forgiveness on a principal residence, up to a maximum of $2 million, and
- Allow certain taxpayers engaged in the real estate business a 20% credit of the amount contributed to any non-profit, Housing and Urban Development (HUD)-approved credit counseling agency that assists homeowners with mortgage problems, and would require the Franchise Tax Board (FTB) to report to the Legislature on an annual basis the aggregate amount of credit claimed.

This bill would also make changes to the Business and Professions Code and the Civil Code to:

- Impose stricter disclosure requirements on real estate agents, and
- Impose penalties on any person who willfully defrauds a creditor by indicating in loan documentation that property is to be owner-occupied when that property is actually intended as rental property.

This analysis will not address the proposed changes to the Business and Professions Code and the Civil Code because they do not impact the department or state income tax revenue.

This is the department's first analysis of SB 1242.

Board Position:			Department Director	Date
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PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to provide some financial relief to homeowners who have found themselves the victims of the recent sub-prime mortgage crisis, and to address some of the practices in the real estate industry that led to this crisis.

EFFECTIVE/OPERATIVE DATES

As an urgency statute, this bill would be effective immediately. The operative dates of the income tax provisions of this bill would be:

1. Credit for Contributions to a Nonprofit HUD-Approved Credit Counseling Agency – would be operative for taxable years beginning on or after January 1, 2008, and before January 1, 2011.
2. Mortgage Debt Forgiveness Relief – would be operative for discharges of indebtedness occurring on or after January 1, 2007, and before January 1, 2010.

POSITION

Pending.

ANALYSIS

1. Credit for Contributions to Nonprofit HUD-Approved Credit Counseling Agency

FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Under federal law, S corporations do not pay an entity-level tax. Generally items of income, loss and credits are passed through to shareholders on a pro-rata basis. Under California law, S corporations pay a 1.5% corporate tax (or 3.5% corporate tax for financial S corporations); and, similar to federal law, generally items of income, loss and credits are passed through to shareholders on a pro-rata basis.

Under California law, S corporations may claim a credit against the corporate tax; however, credits claimed against the corporate-level tax are reduced to one-third of their value because the S corporation tax rate is much lower than the general corporate tax rate of 8.84% (or 10.84% for financial corporations).

THIS PROVISION

This provision would generally allow qualified taxpayers a credit of 20% of the amount contributed to any nonprofit, HUD-approved credit counseling agency that assists homeowners with mortgage problems. The credit would be allowed for taxable years beginning on or after January 1, 2008 and before January 1, 2011, and would be repealed as of December 1, 2011.

"Qualified taxpayer" means a taxpayer, other than a "C" corporation, engaged in the practice of real estate with 20 percent or more of that practice devoted to residential mortgage lending.

This provision would require the FTB to report to the Legislature annually on taxpayer utilization of the credit, unless the Department of Finance separately reports those numbers to the Legislature or budget committees.

IMPLEMENTATION CONSIDERATIONS

This bill uses the phrase "engaged in the practice of real estate with 20% or more of that practice devoted to residential mortgage lending." It is unclear how "20% or more" would be determined and what "devoted to residential mortgage lending" means. The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida does not impose a personal income tax, therefore a comparison to Florida is not relevant. *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* laws do not provide a credit comparable to the credit allowed by this provision.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the revenue loss from this provision would be:

Estimated Revenue Impact Credit for Contributions to Nonprofit HUD-Approved Credit Counseling Agency Provision Effective On or After January 1, 2008 Enactment Assumed After June 30, 2008			
Fiscal Year	2008-09	2009-10	2010-11
Revenue	- $250,000	- $250,000	- $250,0000

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this provision.

Revenue Discussion:

The revenue impact of this provision would be dependent upon the amount of contributions to any non-profit, HUD-approved credit counseling agency, and the number of donors who are engaged in real estate and devote 20 percent or more of their practice to residential mortgage lending.

Real estate industry and departmental contacts suggest there would be limited participation in donations to non-profit, HUD-approved credit counseling agencies by qualified taxpayers. Due to the business closures and job losses in the mortgage industry, revenue loss from credit usage is expected to be negligible, less than $250,000 in any given year.

POLICY CONCERNS

Conflicting tax policies come into play whenever a credit is provided for an item that is also deductible as charitable contribution. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item or cost. On the other hand, making an adjustment to deny the deduction in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

This credit could not be carried over if the taxpayer does not use the entire credit amount in the year claimed. The author may wish to add language allowing a limited carryover period.

2. Mortgage Debt Forgiveness Relief

BACKGROUND

Cancellation of Debt (COD)

If a taxpayer borrows money from a commercial lender and the lender later cancels (“forgives”) the debt, the taxpayer may have to include the cancelled amount in income for tax purposes. When the taxpayer borrowed the money, the loan proceeds were not required to be included in income because the taxpayer had an obligation to repay the lender.

When that obligation is subsequently forgiven, the amount received as loan proceeds is reportable as income because there is no longer an obligation to repay the lender. The lender is usually required to report the amount of COD to the taxpayer and the IRS on a Form 1099-C, Cancellation of Debt.

Example: A taxpayer borrows $10,000 and defaults on the loan after paying back $2,000. If the lender is unable to collect the remaining debt, there is a cancellation of debt of $8,000, which generally is taxable income.

When COD Income is Taxable

While COD income is generally includable as taxable income, there are some exceptions:

- Bankruptcy: Debts discharged through bankruptcy are not considered taxable income.
- Insolvency: If a taxpayer is insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable. A taxpayer is insolvent when the taxpayer's total debts are more than the fair market value of the taxpayer's total assets.
- Certain farm debts.
- Non-recourse loans: A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue the homeowner personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in COD income. However, it may result in other tax consequences, such as capital gain.

  Note: Section 580b of the California Code of Civil Procedure provides that indebtedness incurred to purchase a home in California is non-recourse debt. Therefore, in general, first mortgages in California are non-recourse debt. If a California homeowner refinances that debt, or takes out a home equity loan, the refinanced indebtedness or the home equity loan is generally recourse debt.

A discussion of the tax consequences of a home foreclosure is provided in the attached Appendix.

FEDERAL/STATE LAW

Federal Law

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness (Internal Revenue Code (IRC) sections 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities immediately after the discharge (IRC section 1017).

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. For example, assume a taxpayer who is not in bankruptcy and is solvent owns a principal residence subject to a $200,000 mortgage debt. If the creditor forecloses and the home is sold for $180,000 in satisfaction of the debt, the debtor has $20,000 of income from the discharge of indebtedness.

THE MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007 (P.L. 110-142), *enacted December 20, 2007*

The Mortgage Forgiveness Debt Relief Act of 2007 (the Act) excludes from the gross income of a taxpayer any discharge of indebtedness income by reason of a discharge of qualified principal residence indebtedness occurring on or after January 1, 2007, and before January 1, 2010. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of IRC section 163(h)(3)(B)), up to $2,000,000. Acquisition indebtedness with respect to a principal residence generally means indebtedness incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and secured by the residence. It also includes refinancing of such debt to the extent the amount of the refinancing does not exceed the amount of the indebtedness being refinanced.[1]

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt that is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under this provision.

The individual's adjusted basis in their principal residence is reduced by the amount excluded from income under the Act. Under the Act, the exclusion does not apply to a taxpayer in a Title 11 case; instead, the present-law exclusion applies. In the case of an insolvent taxpayer not in a Title 11 case, the exclusion under the Act applies unless the taxpayer elects to have the present-law exclusion apply.

[1] The term "principal residence" has the same meaning as when used in IRC section 121. (IRC section 121 provides a $250,000 exclusion ($500,000 for married taxpayers filing a joint return) on the gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more. Refer to federal Treasury Regulation section 1.121-1 for the facts and circumstances used to determine "principal residence.")

State Law

Currently, California does not conform to the Mortgage Forgiveness Debt Relief Act of 2007.

The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. An adjustment relating to the income from the discharge of qualified principal residence indebtedness is required under current law. A taxpayer excluding income from the discharge of qualified principal residence indebtedness on the federal individual income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal exclusion.

THIS PROVISION

This provision would conform to the federal Act by allowing an exclusion of up to $2 million of COD income generated from the discharge of qualified principal residence indebtedness. The exclusion would apply to discharges occurring on or after January 1, 2007 and before January 1, 2010.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs and operations.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida does not impose a personal income tax, therefore a comparison to Florida is not relevant. *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* laws do not provide a credit comparable to the credit allowed by this provision.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the revenue loss from this provision would be:

Estimated Revenue Impact of SB 1242 Mortgage Debt Forgiveness Provision As Amended 03/24/2008 Effective for Tax Years 2007, 2008 and 2009 Enactment Assumed After 6/30/2008 ($ in Millions)			
2007-08	2008-09	2009-10	2010-11
-$5	-$8	-$10	-$2

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this provision.

Revenue Discussion:

The revenue impact of this provision would be determined by the amount of qualified principal residence indebtedness discharged and the marginal tax rate of taxpayers otherwise reporting this income.

The revenue loss is estimated as follows:

- The federal estimates by the Joint Committee on Taxation are converted to tax-year estimates ($117 million, $200 million and $261 million for 2007, 2008 and 2009, respectively).
- The federal tax-year estimates are then prorated to California using a proration factor of 4.2%. This proration factor is calculated using four factors:
  - (1) The ratio of California foreclosure to foreclosures nationally using data from RealtyTrac (22%);
  - (2) The ratio of median house price in California to median price nationally (145%), calculated using data from National Association of Realtors and California Association of Realtors;
  - (3) The ratio of qualified taxpayers in California to qualified taxpayers nationally (43%), which is calculated based on assumed differences in percentage of foreclosures involving insolvency, non-recourse loans and non-qualified recourse loans; and
  - (4) The California average marginal tax rate as a percent of the federal average marginal tax rate (31%) — (0.042 = 0.22 x 1.45 x 0.43 x 0.31).

The revenue loss for 2007 tax year is $4.9 million (0.042 x $117 million); for 2008, it is $8.4 million (0.042 x $200 million); and for 2009, it is $11 million (0.042 x $261 million).

Taxable year estimates are converted to fiscal year estimates in the table above.

LEGISLATIVE HISTORY

AB 1918 (Niello and Garcia, 2007/2008) is identical to the mortgage-debt-forgiveness provision of this bill. That bill is currently at the Assembly Revenue and Taxation Committee.

SB 1055 (Machado, et. al, 2007/2008) is similar to the mortgage-debt-forgiveness provision of this bill, except that it limits the amount of the COD exclusion to $1 million (instead of $2 million), and limits the period of excludable discharges to those occurring on or before January 1, 2009 (instead of January 1, 2010. That bill is currently at the Assembly desk.

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Appendix

Tax Consequences of a Home Foreclosure

When a taxpayer loses a home through foreclosure, there are two possible tax consequences:

- Taxable COD income. (Note: As stated above, forgiveness of a non-recourse debt does not result in COD income.)
- A reportable gain from the disposition of the home (because foreclosures are treated like sales for tax purposes). (Note: Often some or all of the gain from the sale of a personal residence qualifies for exclusion from income.)

The following steps illustrate how to compute the income to be reported from a foreclosure:

Step 1 - Figuring COD Income (Note: For non-recourse loans, skip this step. There is no COD income.)

1. Enter the total amount of the debt immediately prior to the foreclosure.___________
2. Enter the fair market value of the property on the date of foreclosure. ___________
3. Subtract line 2 from line 1.If less than zero, enter zero. ___________

The amount on line 3 is taxable COD income, unless one of the exceptions applies.

Step 2 – Figuring Gain from Foreclosure

4. Enter the fair market value of the property foreclosed. For non-recourse loans, enter the Amount of the debt immediately prior to the foreclosure. _________
5. Enter the adjusted basis in the property. (Usually the purchase price plus the cost of any Major improvements.) _____________
6. Subtract line 5 from line 4. If less than zero, enter zero. ____________

The amount on line 6 is the gain from the foreclosure of the home. If a taxpayer has owned and used the home as a principal residence for periods totaling at least two years during the five year period ending on the date of the foreclosure, the taxpayer may generally be able to exclude up to $250,000 (up to $500,000 for married couples filing a joint return) from income. If the taxpayer does not qualify for this exclusion, or the gain exceeds $250,000 ($500,000 for married couples filing a joint return), that portion that does not qualify for the exclusion or exceeds the $250,000/$500,000 exclusion limitation is included in income as a capital gain.

More information is provided on the IRS Web site:
http://www.irs.gov/newsroom/article/0,,id=174034,00.html